A review by the **Federal Reserve Bank of Chicago**

Business Conditions

1961 September

Contents

THE Trend OF BUSINESS

Expansion of economic activity moderated somewhat during the summer, after the very rapid increase which occurred in the spring. Nevertheless, in July, five months after the February low, production, employment and income had increased more rapidly than in the comparable period of 1958 and much faster than in 1949 or 1954.

Between the first and second quarters of 1961 all major categories of outlays by consumers, business firms and governments increased. However, 6.8 billion dollars, or more than 40 per cent of the rise in the rate of total spending on goods and services between these periods, was accounted for by the switch from inventory liquidation to accumulation. Further boosts from this sector are likely to be much less important.

Despite the fact that many business firms are now building inventories, a number of surveys indicate that forward buying is not being pushed vigorously. Evidence of upward price pressures or a significant slowing in delivery schedules could accelerate these programs. Meanwhile, consumers continue a relatively conservative level of spending in relation to their rising incomes. Retail sales eased slightly in July, but most merchants are reported to be expecting a favorable fall season and are ordering from suppliers accordingly.

Absence of a "boom atmosphere," although not uncommon at this stage of an economic expansion, has raised doubts concerning the durability of the upswing. As in the case of other recovery periods, the question is "which forces will boost the economy to full prosperity?" In part, this question was answered by the Administration's decision to extend and accelerate the rise in spending for defense which has been under way since mid-1960. But, unless military outlays are increased very considerably above current plans, there would be considerable "room" for expansion in production and consumption of consumer goods and services, assuming new demands are for the kinds of things manufacturers are equipped to produce.

Defense build-up

The recently authorized increase of about 3.5 billion dollars in defense spending will be used to expand manpower in each of the services, increase combat readiness of active and reserve units, purchase additional armaments and invigorate the civil defense program. About 1.8 billion dollars of the new funds will be used for procurement with a substantial proportion going for wheeled vehicles, ordnance, communications equipment and other items once made in large quantities by Midwest firms.

In each of the fiscal years ending June 30, 1959 and 1960, outlays by the Department of Defense on military functions totaled 41.2 billion dollars. Expenditures in fiscal 1961 were 43.2 billion. New plans may boost spending during the current fiscal year to 46.6 billion dollars or more.

Military spending in recent years has been

about 8.5 per cent of all spending—public and private—on goods and services. Defense procurement, however, has accounted for over 15 per cent of all production classified as "durable goods." The increase in defense spending in the fiscal year just past included only a small increase in procurement. In the months ahead, purchases of arms and equipment are scheduled to rise more rapidly than total military spending.

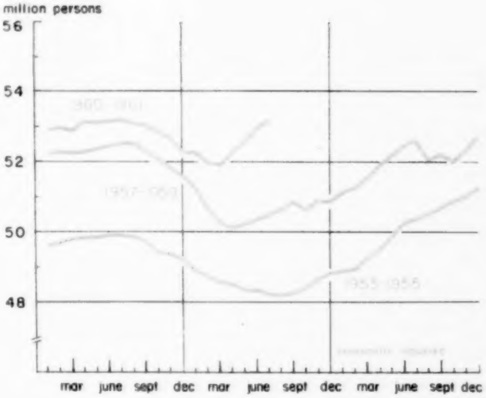
At least 85 per cent of all defense procurement has consisted of aircraft, missiles and ships in recent years. Midwest firms play a relatively minor role in the production of these items. More emphasis is now being given to motorized equipment and ordnance for the army including trucks, personnel carriers and tanks. It is apparent that this trend will accelerate, but announced plans would not raise production of army hardware to levels which even remotely approach those of the Korean War.

Business inventories rising

Typically business inventories decline for several months after the start of an economic expansion because sales to users rise faster than production. In 1958, for example, total business inventories declined for six months after the "trough" of the cycle was reached. In the current year, stocks of goods began to edge up in April only two months after the low point in activity. The moderate rise continued in May and June.

During the second quarter, the book value of total business inventories rose 400 million dollars—only about 2 per cent on an annual rate basis. In the same interval, total sales increased at an annual rate of 12 per cent. As a result the stock-sales ratio (the number of months' sales on hand) dropped from 1.51 to 1.47—the lowest level since the end of the 1959 steel strike.

Nonfarm employment regained pre-recession peak in July after sharp rise



In view of the rapid climb in business sales during the spring, it is remarkable that inventories did not decline for a longer period before turning upward. The reason was the extremely sharp rise in production, 10 per cent between February and July, which was concentrated in the durable goods lines where demand picked up the most.

Because shipments of hard goods manufacturers rose rapidly their inventories did not increase in the aggregate during the spring and early summer. However, inventories of nondurable goods manufacturers did rise during this period.

Inventories of most types of durable goods producers, although stable in the aggregate, declined throughout the second quarter. An important exception is steel where producers were using a portion of their increased output to fill gaps in their own holdings.

Stocks of most retailers have changed little since the low point in the cycle after adjustment for seasonal trends. Sales to consumers have increased but holdings of goods have

been replenished easily by new shipments from suppliers. The principal exception has been automobile dealers whose inventories were rising until the model change-over period after allowance for seasonal trends.

Although business inventories have been increasing since March, stocks on hand appear modest when compared with most earlier postwar years. It is noteworthy, therefore, that there has been little desire on the part of most businessmen to increase their holdings substantially.

Employment up sharply

Between March and July nonfarm wage and salary employment, seasonally adjusted, rose by 1.2 million to 53.2 million. This increase brought employment back to the pre-recession peak reached in July 1960.

The improvement in employment has been twice as fast as during the recovery periods of 1954 and 1958. In those earlier upswings it took two years for employment to regain the pre-recession highs. This development, coupled with the fact that the drop in employment in the 1960-61 decline was much less than in 1953-54 and 1957-58, is evidence that the recent business fluctuation was far milder than the earlier movements.

Manufacturing employment accounted for about half of the rise in total nonfarm wage and salary employment between March and July. Nevertheless, in the latter month the number of manufacturing workers was still 300,000 below the year-earlier figure. This lag has been offset by increased employment in state and local governments and finance and service industries.

Despite the improvement in the labor market unemployment has continued close to 5 million, almost 7 per cent of the labor force. In July it was estimated that 1 million of the unemployed had been out of work six months or more. Certain classes of workers account for disproportional shares of the "long-term unemployed." Men 45 years and over, unskilled and semiskilled workers and nonwhite workers make up relatively large proportions of this group. Workers last employed in durable goods manufacturing represent 27 per cent of the long-term unemployed, although this type of employment accounts for only 13 per cent of total employment.

Insured unemployment nationally was equal to 8.4 per cent of the total number of covered workers last February. By July new hirings and exhaustions of benefits had reduced this proportion to 4.9 per cent. In Illinois the rate was cut from 6.6 to 3.6 per cent during this period, in Indiana from 8.1 to 3.8, in Iowa from 5.5 to 2.6, in Michigan from 13.6 to 5.5 and in Wisconsin from 7.3 to 2.9 per cent. Michigan is the only state in this area in which unemployment has been more severe than in the nation.

Work starts on 1962 autos

In late August virtually all auto makers had begun to turn out limited numbers of new models, a few weeks earlier than in most recent years. August assemblies numbered less than 200,000—the lowest since 1958. In contrast with 1958, September is expected to see a sharp rise. In the fourth quarter, industry projections indicate output of 1.8 million units, the largest since 1955.

On August 1 fewer than 900,000 domestically produced new cars were in stock, about 200,000 less than a year earlier. Because of the cutback in production during August, the new car inventory was expected to be under 700,000 by month end. A few years ago this would have appeared to be a heavy inventory at this time of the year, but industry executives expect that the liquidation of 1961's will proceed smoothly.

In the first half of 1961, 2.9 million cars including imports were sold. This was 15 per cent less than in the same period of 1960 and 6 per cent less than in the first half of 1959. Comparisons with 1960 have improved as the year has proceeded, and in July new car deliveries were very close to last year's level. Surveys of consumers suggest that further relative improvement in car sales will occur in the remainder of the year.

Sales of new cars in most Midwest states have been less vigorous than in the nation as a whole. Illinois, Indiana, Michigan and Wisconsin each reported declines of over 20 per cent during the first six months as compared with the first half of 1960. In Iowa, registrations of new autos almost matched last year, but 1960 sales had been depressed in that state.

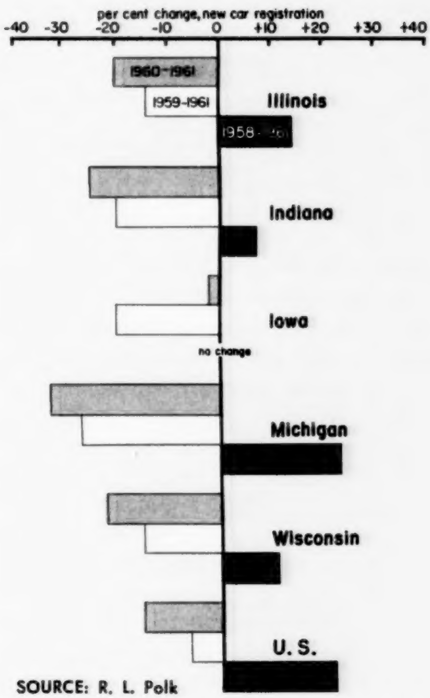
Residential building picks up

During July construction activity reached a record annual rate of 58.7 billion dollars —up 2.9 billion or 5 per cent over the March level. Private residential construction accounted for 90 per cent of this increase.

Construction of public works and public utilities has been relatively stable this year while industrial and commercial construction has declined. New construction contracts indicate that this trend will be reversed soon in the commercial category.

Although residential building has been improving, it is below the peak rates of 1959 and early 1960. Recent evidence indicates that activity in this sector will increase further. During July, requests to the Federal Housing Administration for insurance were at the highest level in 11 months after increasing for three consecutive months. Total housing starts in June and July were at an annual rate of over 1.3 million, far above the depressed rate that prevailed at the beginning of the year and the best since early 1960.

Sales of new cars in the first half of 1961 lagged last year



Housing in the major Midwest cities as a group has followed the national trend fairly closely although there is great variation among individual centers. In the first five months of 1961 permits were 6 per cent below last year for this area, as compared with a 4 per cent decline for the United States. New permits granted in June were 13 per cent above the year-ago level nationally. Most Midwest centers including Chicago, Detroit, Indianapolis and Milwaukee had gains of approximately this magnitude.

Private pension plans continue rapid growth

The means by which individuals provide for economic security in old age have been changing rapidly in recent years with individual accumulations of savings being supplemented increasingly by group pension plans, both private and public. Over 20 million workers, more than one-fourth of the work force, are included in some 25,000 private pension plans. In 1940 the number covered was only about 4 million.[1]

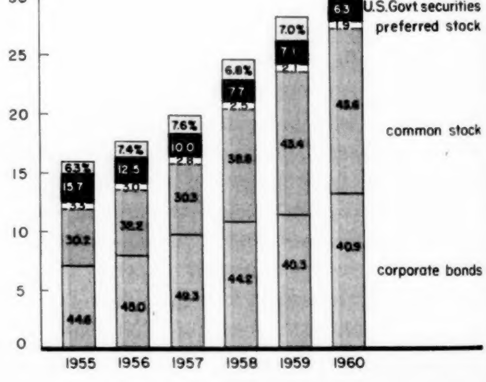
Total assets of these plans rose from 2.4 billion dollars in 1940 to 50 billion at the end of 1960. The increase during the past year exceeded 5 billion. Most of these funds are invested in corporate bonds and stocks. According to the Securities and Exchange Commission, private pension funds purchase more stock than any other investor group. In 1960 their purchases were equal to 52 per cent of net new equity issues; purchases of corporate bonds were equal to 23 per cent of net new issues. Pension plans, therefore, have become an important vehicle for the accumulation and investment of savings.

The growth of private pension plans was accelerated during World War II when shortages of manpower caused keen competition for workers and stabilization policies restrained wage rate increases. This shifted emphasis to the provision of "fringe benefits" as a means of attracting and retaining workers.

A second period of rapid expansion began in 1949 when private pension plans were being adopted in the mass-production industries. Prior to that time labor unions had shown only limited interest in pensions. Retirement programs had generally been considered to be outside the province of collec-

[1]In addition to the private pension plans discussed in this article, there are many publicly administered programs of which the Federal Social Security Program (Old Age, Survivors and Disability Insurance), established in 1935, is the largest by far. It now includes about 90 per cent of all employed workers and benefits and taxes to finance the program have been increased on several occasions. Some of those not covered by the social security program are covered by other publicly administered pension plans. Most workers are now included in group programs and many are covered by both private and public plans.

Assets of noninsured private pension plans are largely in corporate stocks and bonds



tive bargaining and many union leaders looked upon them as "tools of management" —at odds with the primary interests of unions and their members. By 1949 this attitude had changed. The inflationary pressures of the immediate postwar period had subsided, the cost of living had stabilized temporarily, and this argument in support of further boosts of take home pay had become much less persuasive. Union leaders looked with increasing favor upon fringe benefits and began to view private pension plans as desirable supplements to the Federal Social Security Program.

Early in 1949 the National Labor Relations Board, in the Inland Steel decision, ruled that pension plans were a proper subject for collective bargaining. Later that year during the steel strike, the President's Steel Industry Board recommended that the companies develop pension plans for wage earners in the industry. Shortly thereafter pension agreements were signed covering workers in the steel mills and automobile plants and then spread rapidly to other industries. Plans negotiated in collective bargaining include about 60 per cent of all employees covered by private pension plans.

Coverage and assets of private pension plans

	Coverage			Assets (book value)		
	Total	Insured	Noninsured	Total	Insured	Noninsured
	(thousand employees)			(billion dollars)		
1950	9,800	2,600	7,200	11.7	5.6	6.1
1955	15,400	3,800	11,600	26.5	11.2	15.3
1959	20,200	4,800	15,400	44.8	17.5	27.3
1960	—	—	—	50.0	19.0	31.0

Underlying factors

Rapid growth of these plans reflects, in part, basic social and economic changes taking place in the United States — changes which have affected both the needs and the ability of individuals to provide for economic security in old age. The trend toward an urbanized industrial economy with the attendant increase in the number of wage and salary workers has been a factor. Probably more important has been the persistent rise of national income which makes it easier for funds to be set aside for retirement plans. Moreover, it has become necessary for individuals to plan for longer periods in retirement. The average life span has lengthened steadily while retirement age has been lowered. Also, reflecting the general rise in income and levels of living, the standard of an "acceptable" income during retirement has risen.

Group retirement plans tend to be more efficient than individual programs because payment can be based on *average* life expectancy. An individual saver is faced with the fact that the term of his life is uncertain and provision for an adequate retirement income must therefore be estimated on the high side. He can, of course, "work on the basis of averages" by purchasing annuities as an individual. However, such policies are relatively expensive because of higher selling and administrative costs.

Probably the most important factor in the rapid growth of private pension plans is the differential impact of the Federal income tax

as it applies to group and individual programs. The group plans are financed largely by tax deductible contributions from employers. About three-fourths of the plans are financed *entirely* by contributions of employers and nearly 90 per cent of all contributions are from this source. Except where the funds are administered by insurance companies, the earnings on pension fund investments are exempt from taxes until they are distributed as pension benefits.[2] On the other hand, personal income—the source of individual savings—is subject to Federal tax and the earnings on individual savings are taxed currently rather than after retirement. Congress on several occasions has considered proposals that would exempt payments into personal retirement plans by self-employed persons from Federal income tax but has not authorized such action.

Labor mobility

From the standpoint of many employers, pension plans are advantageous because they tend to reduce labor turnover, thereby helping to retain skilled workers and reducing recruiting and training costs. In some cases this reduction in labor mobility may prevent workers from making job changes, desirable on other grounds. The effect, like that of seniority, is to reduce the ability of the labor force to adjust rapidly to different rates of growth of individual firms and industries. The impact is greatest, of course, in the case of older and longer-term workers.

Pension plans also make it more difficult for older workers to obtain employment. A survey conducted by the Department of Labor in 1956 indicated that many employers consider pension costs a significant reason for not hiring workers over 45. This is because pension benefits tend not to be directly proportional to years of employment with pension costs being relatively higher for the older newly hired workers.

The effect upon job flexibility would be less if all pension plans were fully funded and provided for early vesting so that accumulated "rights" to future benefits were not forfeited when workers changed jobs. However, such provisions are usually not in the employer's interest.

In some industries and quite commonly in government employment, individual workers continue to be covered by the same plan even when they change jobs. Possibly one-seventh of all workers covered by private pension plans are in so-called multi-employer plans. But these are usually confined to a localized

[2]*Insured plans* are administered through insurance companies; *noninsured plans,* through a trustee, usually a bank or trust company. A few companies have set up their own trustees. A minority of plans are of the noninsured type but they account for upwards of ¾ of covered employees and about ⅔ of all private pension fund reserves.

Private funds hold nearly half of total pension plan assets, book value, 1960

Private	Billion dollars
Noninsured	**31***
Insured	19
Government	
Federal old age and survivors insurance	20
State and local	19
Civil service	11
Railroad retirement	4
Federal disability insurance	2
Total	106

*About 29 billion dollars is in corporate pension funds, about 2 billion in multi-employer nonprofit organizations and union administered plans.

Private pension plans are large purchasers of corporate securities—1960

Common and preferred stocks	Billion dollars	Per cent of total
Net purchases by:		
Private noninsured pension funds	**1.8**	**52**
Investment companies	1.0	28
Other institutions and foreigners	0.6	17
Individuals, including personal trusts and nonprofit organizations	0.1	3
Total net additions to stocks outstanding	3.4	100
Bonds and notes		
Net purchases by:		
Private noninsured pension funds	**1.4**	**23**
Life insurance companies	1.6	26
State and local gov't. trust funds	1.0	16
Other institutions and foreigners	0.4	6
Individuals, including personal trusts and nonprofit organizations	1.9	29
Total net additions to issues outstanding	6.3	100

SOURCE: Securities and Exchange Commission

industry or service, members of a union or a professional group.

Pension funds and personal saving

Additions to pension fund reserves are generally considered to be part of personal saving. However, unlike savings kept in banks or savings and loan associations which can be converted to cash at the will of the holder, the "owner" does not ordinarily have access to the assets in a pension fund. His claim is conditional. One study of pension funds concluded that probably not more than half of the participants in current plans would ever qualify for any benefits because of changes in jobs, premature retirement or other reasons.

Plans may be terminated because of business necessity. In the case of a merger or the liquidation of a firm, agreements frequently provide that the plan is terminated and benefits being paid may cease. Most plans limit the liability of the employer to the amount of reserves set aside whether or not these are adequate to meet the schedules of pension payments.

Some plans have no advance funding. These are the "pay-as-you-go" plans where current pension costs are paid out of current earnings or "terminal funding" plans where annuities are purchased when eligible pensioners retire. Even the funded plans often are not fully funded in the sense that reserves equal past and prospective pension obligations. Prospective pension claims, of course, are usually uncertain and a strict accounting between assets and liabilities, unlike most savings institutions, is not possible.

Loss or reduction of pensions because of termination or amendment of plans or failure of firms has not been common. However, the chance of loss of prospective pensions constitutes an element of risk to employees in many plans which is not present in the case of most alternative means of providing in-

come for post-retirement years.

Since most individuals cannot consider contributions to group pension plans to be a direct substitute for personal savings held in other forms, the growth of pension funds probably has increased total net saving. If the funds contributed to pension plans had been paid out as wages, some portion of the additional current income undoubtedly would have been spent for current consumption rather than saved and invested. But if wages had not been raised prices of goods and services probably would have been lower and business profits possibly would have been higher. With larger profits, retained earnings of business firms as well as savings of recipients of dividends probably would rise, but these savings would be *after* payment of corporate and personal income taxes.

Investment of reserves

Private pension funds have influenced the flow of savings to users of debt and equity funds. Since pension funds invest largely in corporate securities, they probably have increased the availability of funds to businesses. While their holdings of common stocks are still small relative to the total market value of stocks listed on the New York Stock Exchange—about 4 per cent—the net annual addition of stock to their portfolios accounts for a large proportion of the net increase of all stock outstanding. However, pension funds continue to increase their holdings of stock and this probably exerts an upward pressure on stock prices.

To the extent that pension fund saving has replaced individual saving, there has been a tendency to reduce the availability of funds in mortgage markets. A large portion of individual savings is invested in mortgages through financial institutions such as savings and loan associations, mutual savings banks and commercial banks. Pension funds have not invested importantly in mortgages, although their interest in this type of investment has been increasing recently.

Large stock purchases by pension funds raises the possibility that trustees could influence the management of the firms which these shares represent. It is conceivable also that corporate officers could use pension plan reserves to gain control of other firms—competitors, suppliers or customers—or that unions could use the stock holdings of union-controlled pension funds to influence management. There is little evidence that any of these possibilities are becoming serious problems. Bank trustees, which administer a large proportion of private pension fund reserves, have sought diversification in "quality" stocks rather than control. And instances in which corporations or unions have attempted to use pension fund resources to gain advantages have been rare.

The future of private funds

Private pension funds have become important financial intermediaries serving as depositories for savings and a source of funds for business and mortgage borrowers. They seem destined to grow further as the labor

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force continues to increase. Also, coverage may be extended to additional workers and pension funds now in existence are likely to increase further as most plans have not reached "maturity"— the point where retirements of covered employees assume a normal relation to the number of workers in the plans.

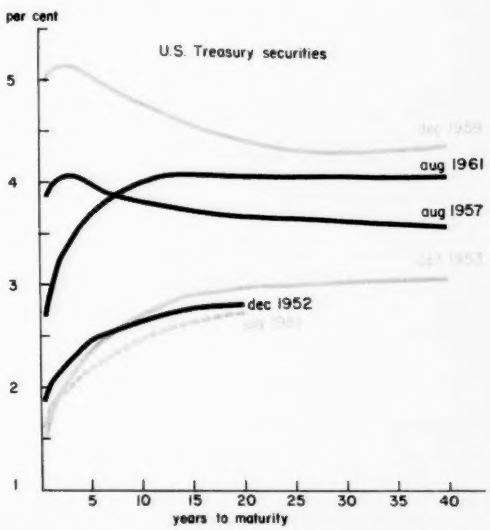
Interest rates in a free market

During the last decade, interest rates in the United States have risen appreciably from the low levels that prevailed in the 1930's and 1940's and have undergone large swings during successive business fluctuations. The increase in yields has reflected the gradual working down of wartime accumulated liquidity and a continued heavy demand for credit in all sectors of the expanding postwar economy. Large amounts of credit were used to finance additions to corporate working capital and fixed plant, residential and commercial construction programs, expansion of governmental facilities and services and the rapid growth of consumer debt. At times investor expectations of further inflation, fed by rising prices and Federal deficits, strengthened the demand for credit and the upward pressure on interest rates.

Interest rates in major European industrial countries also have risen to substantially higher levels with the sharp recovery of their economies from the depressed levels of the early postwar period and their continued vigorous growth in recent years.

Cyclical swings in domestic interest rates have reflected changes in the demand and supply of credit as well as changes in investor expectations. During each business recession private demand for credit has declined and the Federal Reserve System has acted to increase the supply of bank reserves. This, along with continued large or even rising flows of savings, has increased the supply of loanable funds and contributed to a substan-

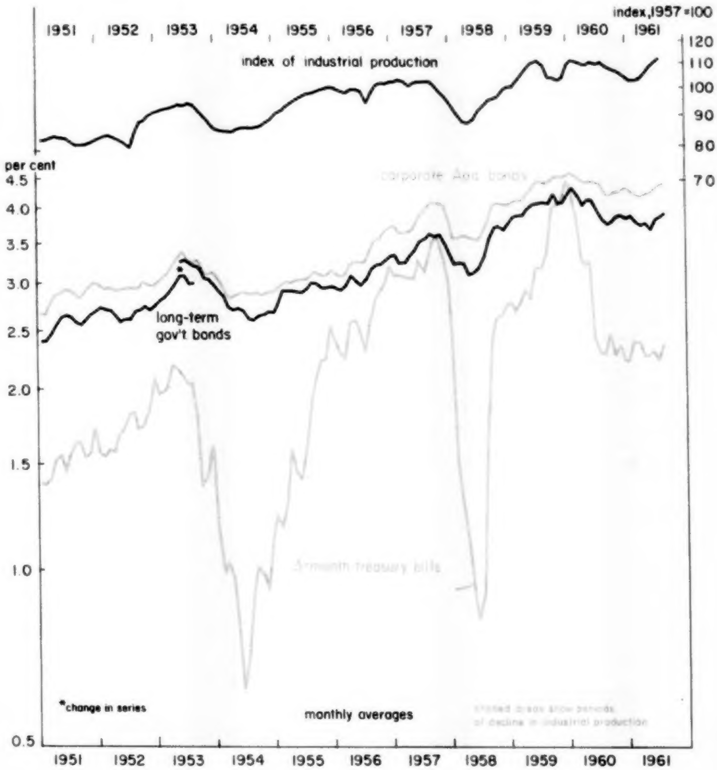
The pattern of yields
can have many different forms



tial easing in the credit markets. As employment and output rose in subsequent recovery periods, the demand for credit has generally grown rapidly, with the result that credit conditions tightened and interest rates rose.

These fluctuations, in turn, have produced markedly different patterns of interest rates on securities. To illustrate, yields on intermediate-term Government securities, on numerous occasions in recent years, have exceeded yields on short- as well as long-term issues—a situation described as a "humped" yield curve. On other occasions, rates on securities with maturities of one year or less have exceeded those on intermediate- and long-term maturities producing an "inverted" or downward sloping yield curve. By contrast, interest rate patterns in the early 1950's typically reflected a situation where yields gradually increased as maturities lengthened.

Since 1951 interest rates have responded sharply to changes in business activity



The 1960-61 experience

Developments in the credit markets during 1960-61, however, have differed significantly from earlier recession-recovery periods. Although interest rates declined in 1960 as credit demands moderated in response to a slower pace of economic activity and following actions by the Federal Reserve to increase the availability of bank credit, the downward adjustment was not as pronounced relative to its previous peak as in 1953-54 and 1957-58—other recent periods of cyclical declines in interest rates. Moreover, the ensuing spread between short- and long-term interest rates widened less. Finally, interest rates did not rise appreciably in the second quarter of 1961 despite the fact that the

economy was undergoing a rapid recovery from the recession and long-term borrowing by business firms and state and municipal agencies had surged ahead sharply.

Through the end of July 1961, yields on short-term securities continued to fluctuate narrowly around the lows reached more than a year earlier, while yields on long-term securities registered only modest increases from the recession lows reached in the late winter of 1961. Interest rates during this period reflected a degree of stability not seen since the 1940's when the Federal Reserve System was supporting the Government bond market.

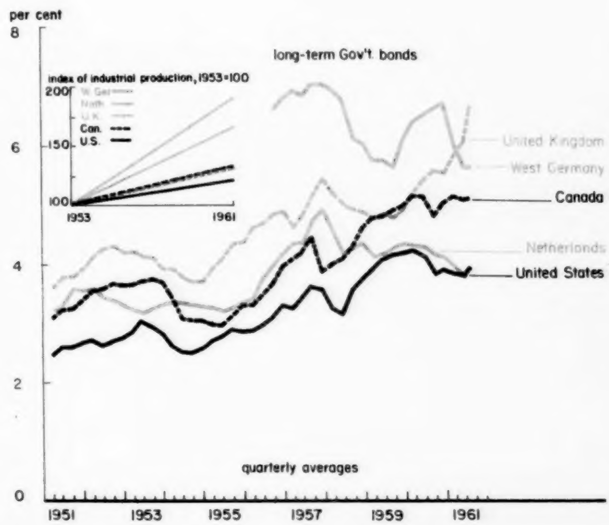
Yields on debt securities of all maturities began declining in January 1960 while most business indicators continued to show strength, expectations remained optimistic and Federal Reserve policy continued restrictive. This decline preceded by roughly five months any general confirmation of a decline in economic activity. The marked shift in position of the U. S. Treasury appears to have been a major factor in this early decline of interest rates, signaling easier conditions in the credit markets. The Federal budget message submitted in January 1960 indicated the Government would run a sizable surplus in its operations through December 1960 compared with a net cash deficit on the order of 8 billion dollars in both 1958 and 1959.

A swing of this magnitude in the Government's credit requirements could materially ease the demand pressure on the credit markets. As projected, a substantial increase in Federal budget receipts combined with lower expenditures during January-June 1960 enabled the Government to make a net cash repayment of 5.8 billion dollars on the Federal debt. In contrast, net Federal cash borrowings had amounted to almost 1 billion dollars in the first six months of 1959 and 7.6 billion in the second half.

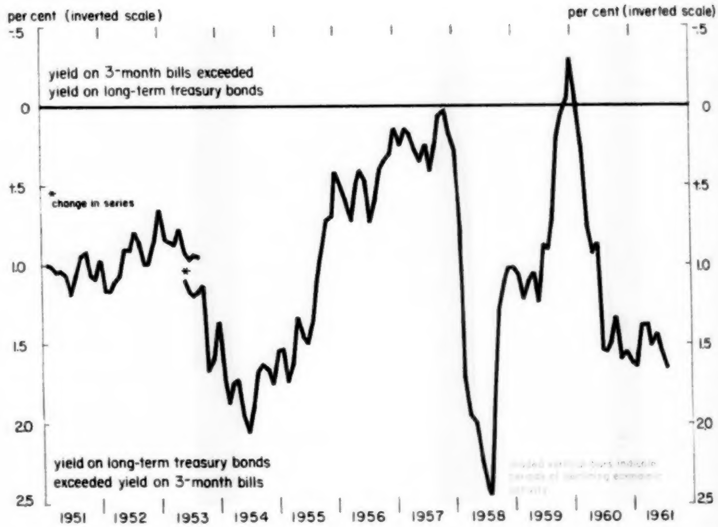
Developments abroad are important

The absence of any further appreciable decline in domestic interest rates after mid-1960, despite further slackening in business activity and easier credit policies, is traceable in substantial degree to developments in the international sector. During the first half of 1960 short-term interest rates in this country and in leading European industrial nations moved in opposite directions, producing a large yield spread in favor of European

Long-term interest rates have risen in major industrial countries



Interest rate spread between long- and short-term U.S. Government securities less pronounced in 1960-61 than in prior recessions



money markets. The higher interest rates abroad primarily reflected a vigorous demand for credit associated with the high levels of European business activity and, to a lesser extent, credit restraints imposed by the monetary authorities to restrain inflationary pressures in their respective countries.

Between January and June 1960 the gross spread between 3-month United States and United Kingdom Treasury bills widened from zero to more than 3 percentage points. In the circumstances the outflow of short-term funds from the United States to Europe accelerated appreciably, partly because foreign and domestic investors alike converted dollars to foreign currencies to take advantage of the higher yields available abroad and as borrowers of funds for use in other countries were attracted by the comparatively low cost of credit in the American market. In the latter part of 1960 these short-term outflows were further accelerated by a deterioration in confidence in the exchange value of the dollar.

"Recorded" net outflows of short-term capital rose from an annual rate of 600 million dollars in the first quarter of 1960 to a record rate of 2.2 billion in the fourth quarter, and it is estimated that sizable amounts of short-term funds, not reflected in the official reporting systems, were also shifted abroad. In the process, the dollar balances of foreign central banks rose substantially and a portion of these higher balances were used to buy gold from the U. S. Treasury. During the year the Treasury's monetary gold stock declined 1.7 billion dollars—with nearly 1 billion occurring in the final three months of the year. This gold drain might have placed severe pressures upon the reserve positions of commercial banks if the effects had not been offset by the Federal Reserve.

Crosscurrents for monetary policy

Higher interest rates, particularly on short-term securities, might have helped to check the outflow of funds from the United States, but the slack in employment and manufacturing in the domestic economy clearly called for a policy of continued credit ease and

this, of course, in a period of easing demand for credit, entails downward pressure on interest rates.

In an effort to avoid contributing to any undue decline in short-term rates which might accelerate the outflow of short-term funds, the Federal Reserve provided the desired reserves to commercial banks largely by means other than purchasing Treasury bills. Beginning in October 1960, the Federal Reserve Open Market Committee placed greater emphasis on the purchase of Government securities other than Treasury bills—certificates, notes and bonds up to 15-months' maturity. Between August and December the Board of Governors initiated changes in member bank reserve requirements and vault cash requirements which added approximately 1.9 billion dollars to member bank reserves. And in the latter part of February 1961 the Federal Reserve Open Market Committee began conducting transactions in the entire range of Government securities.

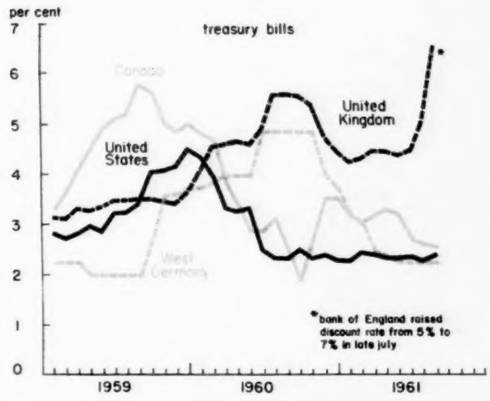
Stability returns to the market

The continued relative stability of interest rates that prevailed in the credit markets during the first half of 1961 reflected, as usual, the interplay of many factors affecting both the demand and supply of loanable funds as well as investor expectations regarding the future course of interest rates. The supply side was augmented by a continued high level of consumer saving reflected in increases in time deposits, savings and loan shares and other personal liquid asset holdings. Net business demand for funds from the securities markets rose to a record 6.2 billion dollars, compared with about 4.5 billion in the first half of both 1959 and 1960. Net borrowings by state and municipal agencies also continued in large volume and at the end of June dealers' inventories of unsold municipals stood at a record 533 million dollars.

These demand pressures, however, were somewhat offset by a lower level of mortgage financing, a slackening in business loan demand from banks and reduced demands for consumer credit. A 3 billion dollar net cash repayment of Federal debt during January-June 1961 also helped the markets to absorb the substantial volume of business and municipal financing without any appreciable tightening of credit or upward movement of interest rates.

But the possible dampening effects on short-term rates of this debt repayment may have been checked by the Treasury's greater reliance upon the issuance of short- and intermediate-term securities in its debt refunding operations as well as sales of such securities by the Federal Reserve for its own account and in behalf of various Government trust funds, with offsetting purchases of longer-term securities.

In 1960 European short-term interest rates rose substantially above those in United States



Note: Monthly average market yields for 3-month bills, except Germany which reflects end-of-month yields.

In recent months the movement of funds abroad, which was a source of considerable upward pressure on interest rates in late 1960, has greatly diminished. Recorded net outflows of short-term funds from this country have declined from an annual rate of 2 billion dollars in the first quarter of 1961 to less than 100 million in the second quarter.

Restoration of international confidence in the dollar was probably the major factor behind these reduced outflows. This renewed confidence stemmed from the U. S. Government's announced determination to maintain the existing gold parity of the dollar as well as from the attainment of an export trade surplus of close to 6 billion dollars, annual rate, in the first half of the year. In addition, interest rates in Europe were reduced late last year and further this year in an effort to discourage large inflows of funds into major European financial centers.

Recently there has been some evidence of short-term funds flowing back to this country in the face of mounting international tension in Europe and—prior to initiation of a British austerity program—uncertainty about the value of the pound. Since the end of February the Treasury has made modest net purchases of gold approximating 80 million dollars. Thus, what previously has been an important drain of funds from the United States was now neutralized, at least temporarily.

Recent developments

Since mid-1961, the broad and vigorous rise in economic activity plus an expansion of Government spending programs (without any immediate tax increases) have contributed to a shift in general expectations in the direction of increased credit demands and possible renewal of inflationary pressures. Gross national product, industrial production and personal income are now at record levels. Reflecting the impact of the President's recent request for an additional 3.5 billion dollars for defense programs, the Government's latest published official estimate of the Federal budgetary deficit for the year ending June 30, 1962, has been increased to 5.3 billion dollars. This compares with a deficit of 3.9 billion for the fiscal year just ended and a 1.2 billion surplus in fiscal 1960.

These developments have tended to strengthen the demand for equities and the preferences for shorter, as compared to longer-term bonds. During the first half of August, common stock prices rose to record highs. Meanwhile, bond dealers reported difficulty in finding buyers at existing prices, and there were further reports of investors switching from long bonds to shorter maturities in anticipation that interest rates would rise. During the last half of August yields on Government securities were at their highest levels in over a year although monetary policy continued "easy" and credit was readily available to all "qualified" borrowers.

Workbook on money revised

The Federal Reserve Bank of Chicago's booklet on the money-creation process, entitled MODERN MONEY MECHANICS — *a workbook on deposits, currency and bank reserves, is now available for distribution to banks, business organizations and educational institutions. Copies may be obtained by request to the Research Department, Federal Reserve Bank of Chicago, Box 834, Chicago 90, Illinois.*

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